

Message Text

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C O N F I D E N T I A L SECTION 01 OF 03 LONDON 18039

E.O. LL652: GDS

TAGS: ENRG, UK

SUBJECT: ECONOMIC AND POLITICAL IMPLICATIONS OF OIL
PRICE INCREASE

REF: STATE 274224

1. SUMMARY. WHILE RELIABLE QUANTITATIVE ESTIMATES CANNOT BE DEVELOPED ON A CRASH BASIS, IT APPEARS TO THE EMBASSY THAT WERE IT NOT FOR THE ALREADY GLOOMY BRITISH ECONOMIC PROSPECTS FOR 1977, A 10 PERCENT OIL PRICE INCREASE COULD BE ABSORBED WITHOUT GREAT STRAIN. HOWEVER, EVEN SUCH A RELATIVELY MODERATE INCREASE WOULD WORSEN PROSPECTS. AN INCREASE OF TWENTY PERCENT COULD CHANGE PROSPECTS FROM SLUGGISH GROWTH TO STAGNATION' WITH CONSEQUENTIAL EFFECTS ON THE "SOCIAL CONTRACT" UPON WHICH THE CURRENT GOVERNMENT'S POLITICAL SUPPORT IS BASED. END SUMMARY

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2. THE EMBASSY CANNOT IN THE TIME ALLOWED UNDERTAKE

A DETAILED, QUANTITATIVE ANALYSIS OF THE EFFECTS ON THE ECONOMY OF POSSIBLE OPEC-DICTATED PRICE INCREASES WHICH WOULD BE RELIABLE ENOUGH TO BE USEFUL. (IT NOTES THAT CIA HAS RECENTLY DONE SO; THE SUMMARIZED RESULTS AVAILABLE HERE ARE INTERESTING, BUT IT IS UNCLEAR HOW THEY WERE ARRIVED AT). BUT WE CAN TRY TO GIVE AN IMPRESSION OF THE SIZE OF THE PROBLEMS 10 PERCENT AND 20 PERCENT INCREASES MIGHT CREATE.

3. IN DEVELOPING THESE IMPRESSIONS, WE USE THE FOLLOWING ASSUMPTIONS:

A. BRITAIN IS RELATIVELY LESS DEPENDENT ON OIL (FOR ROUGHLY 42 PERCENT OF ITS ENERGY REQUIREMENTS) THAN MOST OF THE OTHER MAJOR INDUSTRIAL NATIONS.

B. IT HAS INDIGENOUS (NORTH SEA) OIL RESOURCES, PRODUCTION FROM WHICH SHOULD RAPIDLY INCREASE DURING 1977 SO AS TO SUPPLY ROUGHLY 40 PERCENT OF TOTAL OIL DEMAND.

C. BRITAIN'S GDP WILL RISE ONLY marginally IN 1977 -- RUNNING ABOUT 2 TO 2-1/2 PERCENT ABOVE 1976, AND OIL DEMAND WILL SIMILARLY INCREASE ONLY SLIGHTLY. OUR ROUGH ESTIMATE, BASED ON THIS AND THE PREVIOUS ASSUMPTION, IS THAT IN 1977 NET CRUDE IMPORTS WILL AMOUNT TO 62 MILLION TONS (VS 85 MILLION IN 1976) AND NORTH SEA CRUDE PRODUCTION WILL BE 40 MILLION TONS (15 MILLION IN 1976).

D. THE DOMESTIC PRICE OF NORTH SEA CRUDE WILL CONTINUE TO BE ABOUT THE SAME AS THE LANDED COST OF IMPORTED CRUDE.

E. THE OVERALL RATE OF INFLATION IN THE UK WILL BE IN THE 13-16 PERCENT RANGE - EVEN IF OIL PRICES DON'T RISE.

F. GOVERNMENT AND INDUSTRY HAVE RESIGNED THEMSELVES TO OPEC INCREASES IN 1977 OF UP TO 10 TO 12 PERCENT; SUCH INCREASES ARE TO SOME DEGREE BUILT INTO CONFIDENTIAL

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FORECASTS AND BUSINESS EXPECTATIONS.

G. THE GOVERNMENT, FRIGHTENED OF THE POSSIBILITIES FOR REKINDLING HYPER-INFLATION, AND CONSTRAINED BY THE POLICY REQUIREMENTS OF ITS INTERNATIONAL CREDITORS, WILL NOT "ACCOMMODATE" HIGHER OIL PRICES BY EQUIVALENT STIMULUS TO THE ECONOMY. THE OVERALL EFFECT OF OIL PRICE INCREASES WILL THEREFORE BE DE-

FLATIONARY.

4. BASE PREDICTION FOR 1977. WITH UNCHANGED OPEC PRICES. BRITAIN'S CRUDE OIL IMPORTS WOULD PROBABLY COST 3.4 BILLION POUNDS IN 1977 AS AGAINST 4.3 BILLION POUNDS IN 1976. THIS WOULD BE THE NET RESULT OF A REDUCTION IN OIL IMPORTS OF 23 MILLION TONS DUE TO INCREASED NORTH SEA PRODUCTION OFFSET BY A ROUGHLY 10 PERCENT DEVALUATION OF THE POUND FROM ITS AVERAGE

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1976 VALUE. TAKING THE COST OF NORTH SEA CRUDE INTO ACCOUNT. THE TOTAL INCREASE IN THE OIL BILL WOULD BE ABOUT 500 MILLION POUNDS.

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5. EFFECT OF 10 PERCENT INCREASE. SUCH AN INCREASE WOULD BOOST THE IMPORT BILL (WORSEN THE BALANCE OF

TRADE) BY ROUGHLY 340 MILLION POUNDS. THE INCREASE IN NORTH SEA PRICES TO MATCH OPEC PRICES WOULD BRING THE INCREMENTAL EFFECT ON THE OIL BILL, ABOVE THE BASE PREDICTION, TO ABOUT 560 MILLION POUNDS.

6. EFFECT OF 20 PERCENT PRICE INCREASE. THE IMPORT BILL WOULD BE 680 MILLION POUNDS MORE THAN IN THE BASE PREDICTION. INCLUDING NORTH SEA OIL, THE TOTAL OIL BILL INCREASE WOULD BE ON THE ORDER OF 1.1 BILLION POUNDS. THIS IS AN OUTSIDE FIGURE, AS A PRICE HIKE OF THIS MAGNITUDE WOULD REDUCE CONSUMPTION
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AND PRODUCE SOME DRAWDOWN IN STOCKS.

7. ASSESSMENT. THE FIGURES SET FORTH ABOVE ARE EXTREMELY ROUGH AND AT BEST SHOW THE ORDERS OF MAGNITUDE INVOLVED. THEY HAVE TO BE SEEN IN THE CONTEXT OF AN ECONOMY THAT IS SUFFERING SIMULTANEOUSLY FROM INFLATION, SLOW GROWTH, HIGH UNEMPLOYMENT AND A BALANCE OF PAYMENTS DEFICIT. IN THESE CIRCUMSTANCES, EVEN MINOR ADDED HANDICAPS CAN BE SIGNIFICANT.

8. WE THINK ON THE OTHER HAND, THAT THE POSSIBILITY OF SOME INCREASE IN OIL PRICES HAS BEEN FORESEEN. FOR EXAMPLE, THE TREASURY. IN ITS JULY ASSESSMENT OF "THE NORTH SEA AND THE BALANCE OF PAYMENTS", ASSUMED THAT OIL PRICES WOULD RISE "AT THE SAME RATE AS WORLD PRICES OF MANUFACTURED EXPORTS". A 10 PERCENT INCREASE IS NOT OUT OF LINE WITH THIS PREDICTION. SOMEWHAT SIMILARLY, THE NATIONAL INSTITUTE REVIEW OF AUGUST. ALLOWED FOR A RISE "OF THE ORDER OF 7 PERCENT IN OCTOBER. FOLLOWED BY 5 PERCENT AT MID 1977".

9. IT IS TRUE THAT THE POUND HAS RESUMED ITS DECLINE SINCE THESE TWO FORECASTS WERE PUBLISHED. IT WOULD APPEAR, THEREFORE, THAT A 10 PERCENT PRICE RISE IN TERMS OF STERLING IS INEVITABLE IN 1977 AS COMPARED TO 1976 EVEN WITHOUT AN OPEC BOOST; A 10 PERCENT INCREASE. THEREFORE IS MORE SIGNIFICANT THAN IT WOULD HAVE BEEN. BUT EVEN THE CUMULATIVE IMPACT OF STERLING DEVALUATION AND A 10-15 PERCENT OIL PRICE INCREASE IS TAKEN INTO ACCOUNT IN THE RECENT PHILLIPS AND DREW FORECAST, WHICH NEVERTHELESS PREDICTS A 2.7 INCREASE IN GDP IN 1977.

10. WE SUSPECT THAT IT IS AT OR TOWARD THE 20 PERCENT LEVEL THAT AN INCREASE WOULD REALLY PINCH. AND THE PINCH WOULD BE IRREMEDIABLE, SO FAR AS WE CAN SEE. THE GOVERNMENT IS ALREADY FACED WITH A FRIGHTFUL

DILEMMA. CURRENT SPECULATION HAS IT THAT SLUGGISH
ECONOMIC GROWTH IS LIKELY TO PUSH THE PUBLIC SECTOR
BORROWING REQUIREMENT, BECAUSE OF LOWER GOVERNMENT
REVENUES, TO 11 BILLION POUNDS (IN 1975/76 VALUES)
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IN 1977. ADDITIONAL STIMULUS TO THE ECONOMY TO
COMPENSATE FOR THE OIL DRAG IS VIRTUALLY UNTHINKABLE.
THUS, AN OIL PRICE INCREASE OF AROUND 20 PERCENT COULD
BE EXPECTED TO REDUCE GDP. OUR GUESS IS THAT THE
REDUCTION MIGHT BE ON THE ORDER OF HALF A PERCENT,
PERHAPS MORE. DEBITED AGAINST PROSPECTIVE 1977 GROWTH
OF ONLY 2-1/2 PERCENT, THE RESULT WOULD BE TO PRODUCE
NEAR STAGNATION IN OUTPUT. AND WITH A TREND GROWTH
IN PRODUCTIVITY OF 2-1/2 TO 2-3/4 PERCENT, UNEMPLOYMENT,
CURRENTLY ALREADY AT A POST-WAR RECORD LEVEL OF 5.6
PERCENT, COULD SOAR.

11. ON THE OTHER HAND, ON THE BASIS OF OUR ASSUMPTION
THAT THE UK GOVERNMENT WOULD NOT THIS TIME, AS IT
DID IN 1974-75, "ACCOMMODATE" THE OIL PRICE INCREASE,
THE INFLATIONARY EFFECT SHOULD BE RELATIVELY MINOR.

12. OUR ASSESSMENT AS REGARDS THE IMPACT ON STERLING
IS ESSENTIALLY THE SAME: A 10 PERCENT PRICE INCREASE
WOULD BE BAD BUT NOT DISASTROUS; A 15-20 PERCENT
INCREASE WOULD PRODUCE A LARGE ENOUGH SWING TO HURT.
THERE IS NO REASON TO THINK ADDITIONAL OPEC
RECEIPTS WOULD BE HELD IN STERLING.

13. IT SHOULD BE NOTED THAT THE TIME PATTERN OF THE
EFFECT OF A PRICE INCREASE MAY BE RATHER SPECIAL IN

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THE BRITISH CASE. NORTH SEA PRODUCTION SHOULD BE GROWING RAPIDLY DURING THE YEAR, SO THE ADVERSE BOP EFFECT SHOULD DIMINISH PROGRESSIVELY IN 1977. ON THE OTHER HAND, TAKING LAGGED EFFECTS OF PRICES ON OUTPUT INTO ACCOUNT, THE DEFLATIONARY EFFECT MAY BE MORE PRONOUNCED LATER IN THE YEAR.

14. FINALLY, THE POLITICAL IMPLICATIONS. A GROWTH IN UNEMPLOYMENT DUE TO A SLOWING DOWN OF OUTPUT GROWTH WOULD SEVERELY STRAIN THE "SOCIAL CONTRACT" BETWEEN THE TUC AND THE GOVERNMENT. THE TUC HAS SEEN THIS DEAL AS A NEAR-TERM SACRIFICE OF WAGE INCREASES FOR THE SAKE OF GREATER OUTPUT AND EMPLOYMENT IN THE LONGER TERM. SUCH A PAYOFF ALREADY SEEMS UNLIKELY IN 1977; WITH INFLATION CONTINUING, ANY WORSENING OF CONDITIONS FROM THOSE ALREADY FORECAST COULD BRING THE WAGE TRUCE TO AN END. (THE SECOND ROUND OF THE TUC WAGE DEAL ENDS
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JULY 31; IT MAY BE JUST ABOUT THEN THAT THE ECONOMY WOULD REALLY BEGIN TO DISPLAY MARKED SIGNS OF THE EFFECT OF AN OIL PRICE INCREASE.)

15. IF THE TUC THEN BECAME SERIOUSLY RESTIVE, THE GOVERNMENT MIGHT EITHER PERSIST IN ITS RESTRICTIVE ECONOMIC POLICIES, AND LOSE ITS POLITICAL BASE; OR, MORE LIKELY, YIELD TO "POLITICAL NECESSITY" AND "ACCOMMODATE" THE OIL PRICE INCREASE, POSSIBLY ACCOMPANYING THIS WITH IMPORT RESTRICTIONS IN AN EFFORT TO DEAL

WITH THE PROBLEMS RENEWED HIGHER RATES OF BRITISH
INFLATION WOULD CAUSE.

16. TO SUM UP, THE FRAGILITY OF THE BASIC ECONOMIC
SITUATION WILL MAKE IT DIFFICULT FOR THE BRITISH GOVERN-
MENT TO COPE WITH PRICE INCREASES WITHOUT RUNNING INTO
DIFFICULTIES THE MAGNITUDE OF WHICH WOULD INCREASE WITH
THE MAGNITUDE OF THE PRICE INCREASE, AND WHICH WOULD
BECOME ACUTE IF THE PRICE INCREASE IS 20
PERCENT.

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